ST 00-0162-GIL 08/08/2000 COMPUTER SOFTWARE

> The taxation of software is discussed in regulations found at 86 Ill. Adm. Code 130.1935. (This is a GIL.)

August 8, 2000

Dear Xxxxx:

This letter is in response to your letter received April 25, 2000. We regret our delay in responding. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department.   See, 2 Ill. Adm. Code 1200.120 (b) and (c), which can be found at http://www.revenue.state.il.us/legalinformation/regs/part1200.

In your letter you have stated and made inquiry as follows:

Our client (the "Company") provides commercial customers (the "Merchants") with an integrated electronic commerce solution (the "Product") consisting of hardware, software, web hosting services, and services designed to automate the Merchant's entire order life cycle. Revenues are realized through the execution of contracts for the Product that typically runs for a twenty-four month period. During the twenty-four month period, the Company realizes several standard revenue streams related to various portions of the Product. In addition to its standard fees, Merchants may incur other fees for supplemental software and/or services beyond the standard services offering.

The Company deploys the Product over a period of approximately three to five months. Upon commencement of the Product's deployment, one or more employee representatives of the Company conduct what is typically a three day business process review ("BPR") to gain an understanding of the Merchant's business and orient or educate the Merchant about how to use the Product. Although integral to the successful deployment of the Product, the Company believes that no portion of its fee for the Product is related to the BPR.

During the BPR, Merchants are provided with a graphical user interface ("GUI") disk free of charge. The GUI disk holds the interface/web browser software necessary for a Merchant to use the Product. Although the GUI browser is required to utilize the Product, it has no intrinsic value by itself. Accordingly, there are no license numbers/revenues associated with it. Finally, if our client did not provide the GUI browser, the Merchants could acquire a compatible GUI browser, free of charge, from another source with minimal effort.

The Company also provides the Merchants with one hard copy of the Product's training materials at no cost. The training materials are made available to the general public via the Company's web site. In the event that a Merchant loses its hard copy of the training materials and requests a new copy, the Company would advise the Merchant to download a copy from the Company's web site.

Apart from the free materials and services provided in conjunction with the Product's deployment, the Company charges for and assigns the vast majority of its value-add to web hosting, software licensing, and the accompanying operation/service, maintenance and support.

As stated above, revenues for the Product are realized through the execution of contracts. Rate sheets attached to the contracts itemize the charges that are associated with specific hosting and software licensing products and services. The following narration details the Company's revenue streams and the product/service combinations related thereto:

(1) Hosting

Approximately two to three months after the execution of the sales contract, computer web servers (hardware) are rented from third parties (the Company's "Hosting Partners") configured according to the Company's standard configuration, and designated for use by the Merchant. The web servers are located, supported and maintained outside of Illinois. Moreover, the web servers are located, supported and maintained either by the Company or its Hosting Partners. The web servers contain (host) and store the software and data described under (2) below.

Once the computer web servers are designated, Merchants are charged a markup on the Hosting Partners' fees to the Company. Hosting fees are typically charged to the Company at rates that vary with the type of server and amount of space provided by the Hosting Partner.

(2) Software Licensing, Service Operation and Maintenance

Beginning at the inception of the contract and at the end of each month following, the Company charges a base fee (a good faith deposit at inception and continuing monthly base fees) for operation, maintenance, and support services and the non-exclusive assignable right to use both third party and Company generated software. The Company believes that the large majority of its fees are related to operation, maintenance and support services. The ultimate and ongoing purpose of the software/service combination is enabling the business of the Merchant to be conducted worldwide over the Internet.

If the Merchant's use of the Product is successful, an increase in the Merchant's revenue transaction with their customers will likely result. An increase in the Merchant's revenue transactions has a direct relationship with the costs of providing operation, maintenance and support services. Thus, in addition to the base fee, once the Product is fully deployed, the Company charges a transactional fee in the form of a percentage markup on the Merchant's revenue transactions with their customers. As stated above, the software and any data generated by it is contained, stored, and maintained on servers located outside of Illinois. To use the software and transact the business of a Merchant, the Merchants located in Illinois connect to the web based servers via the Internet. Aside from the GUI browser, no software is ever transferred to or stored on any medium in Illinois.

(3) Ancillary Services

Finally, on occasion, the Company may provide additional consulting/development services for the Merchants. Such services may include the design and development of a Merchant's web site or Merchant specific training. For these services, the Company charges for time and materials.

The web site development services will be performed entirely outside of Illinois. The Merchant specific training may be conducted either within or outside of Illinois, depending on the Merchant's needs.

Issue

Assuming that Illinois has jurisdiction to tax the Company, please advise as to whether each revenue-generating product or service is subject to sales/use taxation in Illinois. Please assume that base, transactional, and hosting fees are separately stated on the rate sheet accompanying the contracts for the Product.

In addition, please advise as to whether any other aspects of the Product (as specified above) may be subject to sales or use tax in Illinois.

Under a separate scenario, please advise as to whether the true object of the Product is providing various services. Accordingly, if a single lump fee is charged, could the revenues from the product be classified by Illinois either in whole or part as nontaxable services?

The Retailers' Occupation Tax imposes a tax upon persons engaged in the business of selling tangible personal property at retail. A "sale at retail" is the transfer of the ownership of, or title to, tangible personal property to a purchaser, for use or consumption and not for resale in any form as tangible personal property, for a valuable consideration. See the enclosed copies of 86 Ill. Adm. Code 130.101 and 130.201.

A few preliminary assumptions must be made before any general discussion of these transactions. Your letter is not clear regarding the location at which the contract is entered into with Illinois customers. We assume, for purposes of this letter, that the contract is accepted by the Company at a location outside of Illinois. Because of the presence of the Company's employees in Illinois during the BRP process, we believe that the requisite nexus is established to require that the Company act as a Use Tax collector.

During the BPR process, the Company provides Merchants with GUI software. When persons give away tangible personal property in Illinois free of charge, they are considered to be making a use of the property. Accordingly, Use Tax is incurred by such donors. As you can see from the enclosed copy of 86 Ill. Adm. Code 130.1935, canned computer software constitutes tangible personal property subject to tax. When the Company provides canned software to Merchants free of charge, it will incur a Use Tax liability on its cost price of the tangible personal property transferred to Merchants. Similarly, the Company also appears to provide a hard copy of its training manuals to Merchants as part of the BRP process. We assume that the training manual, since it is also available to the general public, is not of a customized nature. This being the case, the Company will also incur a Use Tax liability on its cost price of the hard copy of the training manual that is given away in Illinois.

Your letter describes a series of transactions that occur after the BRP process is completed. These transactions center around the use of software by Merchants. Itemized charges are made by the Company for hosting services and for base and transactional fees. Hosting fees are charged for transactions in which no tangible personal property is transferred to Merchants. Rather, these fees represent charges for the Merchants' use of web servers located outside Illinois. Although not entirely clear from your letter, it appears that the Company leases web servers from "Hosting Partners" and passes marked-up costs for its lease of the web servers onto Merchants. Transactions in which no tangible personal property is transferred do not trigger either Retailers' Occupation Tax or Use Tax, or Service Occupation Tax or Service Use Tax liability.

Your letter indicates that the base fee (as well, apparently, as the transactional fee) is charged for the "non-exclusive, non-assignable right to use both third party and Company generated software." Merchants use

this software to "automate their entire order life cycle." Data entered by Merchant during his use of this software is stored on the web server that hosts the software.

We are unable to issue a ruling regarding the taxability of these charges without more specific information regarding the specific nature of these transactions. In Illinois, the transfer of canned computer software is subject to Retailers' Occupation Tax and Use Tax, regardless of the form in which it is transferred or transmitted. See the enclosed copy of 86 Ill. Adm. Code 130.1935. Canned software that is transferred or transmitted electronically is specifically subject to Retailers 'Occupation Tax and Use Tax. See 86 Ill. Adm. Code 130.1935 (a).

Section 2-25 of the Retailers' Occupation Tax Act defines the term, "computer software," as **a set of statements, data or instructions to be used directly or indirectly in a computer in order to bring about a certain result in any form in which those statements, data or instructions may be embodied, transmitted, or fixed, by any method now known or hereafter developed, regardless of whether the statements, data, or instructions are capable of being perceived by or communicated to humans, and includes prewritten or canned software that is held for repeated sale or lease, and all associated documentation and materials, if any, whether contained on magnetic tapes, discs, cards, or other devices or media, but does not include software that is adapted to specific individualized requirements of a purchaser, custom-made and modified software designed for a particular or limited use by a purchaser, or software used to operate exempt machinery and equipment used in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease. For purposes of this Act, computer software shall be considered to be tangible personal property.** See, 35 ILCS 120/2-25.

It appears, based upon the limited information contained in your letter, that the Company is engaged in the business of providing software to Merchants. Merchants use this software, directly or indirectly in their computers, to "bring about a certain result" (e.g., to automate their order cycle). As indicated in the statutory definition of "computer software," the statements, data or instructions may be "embodied, *transmitted*, or fixed, by any method now known or hereafter developed." The statements need not be capable of perception by humans. The definition of "computer software" found in Section 2-25 of the Retailers' Occupation Tax is very broad, and clearly envisions taxation of software which is transmitted electronically (" … in any form in which those statements … may be transmitted …."). The Department's regulation governing the taxation of software has long contained a provision to this effect. See the enclosed copy of 86 Ill. Adm. Code 130.1935 (a).

The statute is also written broadly in other respects. Specifically, the statutory definition recognizes, and in particular does not limit, the form or method by which the software is transmitted to or used by purchasers. Section 2-25 states that software is not limited to that used only "directly" in a computer. It also includes a set of statements, data, or instructions *to be used … indirectly in a computer … in any form in which those statements … may be* embodied, *transmitted*, or fixed, *by any method now known or hereafter developed* …."." From the information provided in your letter about your client's activities, we are not prepared to advise that this definition would not encompass the use of software accessed remotely and used interactively in the computers of Illinois Merchants.

As you can see from the Department's regulation governing computer software, licenses of software are not taxable if they meet the criteria specified at 86 Ill. Adm. Code 130.1935 (a)(1)(A) - (E), to wit:

A)   it is evidenced by a written agreement signed by the licensor and the customer;

B)   it restricts the customer's duplication and use of the software;

C)   it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party);

D)   the vendor will provide another copy at minimal or no charge if the customer loses or damages the software; and

E)   the customer must destroy or return all copies of the software to the vendor at the end of the license period.

Several of the criteria enumerated in the regulation have been modified. The Department has deemed software licenses to meet the criteria of subsection (D) even if they do not contain a provision requiring the vendor to provide another copy at minimal or no charge, as long as the vendor's records reflect that he has a policy of providing copies of software at minimal or no cost if the customer loses or damages the software. The Department has also deemed perpetual license agreements to meet the criteria of subsection (E), even though no provision is included in the software licenses which requires the return or destruction of the software.

We wish to emphasize that we have based our response on our limited understanding of the transactions you have sketched in your letter. We would be happy to reexamine our response upon provision of detailed information regarding the nature of these transactions.

I hope that this information is helpful. The Department maintains a web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding the transactions which you have described, please submit all of the information set out in items 1 through 8 of Section 1200.110 (b).

Very truly yours,

Jerilynn Troxell Gorden
Senior Counsel, Sales & Excise Tax

Enc.